11 and the Court's recent decision in *Dura*, and therefore warrants certiorari and reversal.

CONCLUSION

The decisions below reflect both a Circuit split and a stark conflict with this Court's precedents and the statutory text on determining materiality under Section 11. The decisions below conflict with this Court's intervening decision in *Dura v. Broudo* by depriving Petitioners of recovery for a $40 million loss directly attributable to the public realization of the issuer's imminent bankruptcy, which Respondent knew and failed to disclose. This Court should settle the two questions presented in the Petition to restore the special protection Congress intended Section 11 to provide to purchasers in registered securities offerings.

Petitioners therefore respectfully request this Court to grant the writ of certiorari.

Respectfully submitted,

PHILIP BOROWSKY
Counsel of Record
CHRISTOPHER JAMES HAYES
BOROWSKY & HAYES LLP
One Market Plaza
Steuart Tower, Suite 1275
San Francisco, CA 94105
Telephone: (415) 896-6800
Facsimile: (415) 896-0600

Attorneys for Petitioners

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In The
Supreme Court of the United States

CHARLES T. MADDEN, et al.,

Petitioners,

v.

DELOITTE & TOUCHE LLP,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR REHEARING

PHILIP BOROWSKY
Counsel of Record
CHRISTOPHER JAMES HAYES
BOROWSKY & HAYES LLP
One Market Plaza
Steuart Tower, Suite 1275
San Francisco, CA 94105
Telephone: (415) 896-6800
Facsimile: (415) 896-0600

Attorneys for Petitioners

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PETITION FOR REHEARING

Petitioners respectfully move this Court for an order (1) vacating the denial of the Petition for a Writ of Certiorari, entered on October 3, 2005, and (2) granting that Petition. As grounds for this motion, Petitioners state the following:

Two events virtually coinciding with this Court's denial of the Petition warrant rehearing. First, this Court has granted certiorari in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* No. 04-1371, part of the coordinated litigation captioned *Merrill Lynch & Co. Research Reports Securities Litigation*. Another of the *Merrill Lynch* cases resulted in a published opinion in the Southern District of New York, the leading venue for securities actions, that addresses the first question presented in the Petition: whether information outside securities filings can excuse Securities Act liability for otherwise material misstatements or omissions, absent proof that the undisclosed information was actually known to investors or so widely disseminated that its omission was not materially misleading. Now on appeal to the Second Circuit, the *Merritt* opinion agrees with the Ninth Circuit's decision in the instant case but deepens an existing conflict with the Third and Fifth Circuits. Even if the Second Circuit reverses, as the SEC has urged in an *amicus curiae* brief, a published split of authority will remain unless this Court grants certiorari.

Second, the resolution of this question has become even more critically important since the American Institute of Certified Public Accountants released a controversial white paper for auditing firms to adopt as official policy for "due diligence" in merger transactions like

Petitioners' transaction. Under this white paper, auditors would refuse to disclose their knowledge of fraud, illegal acts, or misinformation by company management. Securities industry leaders have condemned the AICPA's white paper as part of a "disturbing trend of auditor withdrawal from the due diligence process."[1] These actions threaten not only investors in the securities issued under materially misstated registration statements, but also "the very vitality of our capital markets" because they undermine public confidence in auditor disclosures.[2] Respondent's actions in the instant case anticipated this same trend of auditors attempting to minimize or evade their disclosure duties under Section 11 of the Securities Act.

The instant case presents the best vehicle for resolving timely and critical issues of auditor liability under Section 11. The named Petitioners lost $40 million after Respondent misstated the issuer's financial condition and failed to disclose its knowledge that the securities issuer had fallen into grave danger of bankruptcy. Petitioners had no actual knowledge of the danger of bankruptcy, and no public domain information warned of any risk of bankruptcy. And yet the courts below held that analyst reports commenting on some aspects of the issuer's earnings

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[1] Letter from Micah S. Green, President and CEO, The Bond Market Association, and Marc E. Lackritz, President, Securities Industry Association, to Donald T. Nicolaisen, Chief Accountant, Securities & Exchange Commission, at 3 (Oct. 13, 2005) (available at www.sia.com/2005_comment_letters/8594.pdf).

[2] *See* Letter from the Financial Reporting Committee of the Association of the Bar of the City of New York to the Center for Public Company Audit Firms, American Institute of Certified Public Accountants, at 2 (Sept. 30, 2005) (available at www.nycbar.org/pdf/report/White_Paper_letter.pdf).

reporting but saying nothing of potential bankruptcy rendered immaterial Respondent's admitted misrepresentation of the issuer's financial condition.[3]

The Petition presents issues critical to the integrity of the national capital markets and the system of investor protection through full disclosure Congress implemented in the Securities Act of 1933. This Court should therefore vacate the denial of the Petition for a Writ of Certiorari and grant that Petition.

I. The Grant of Certiorari in *Merrill Lynch v. Dabit* Warrants Rehearing and Certiorari in the Instant Case.

On September 27, 2005, only six days before the denial of certiorari in the instant case, this Court granted certiorari in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* No. 04-1371,[4] on the question whether SLUSA[5] preempts certain state-law securities claims. *Dabit* is part of a series of 120 coordinated actions by stock purchasers and stock brokers challenging Merrill Lynch's allegedly biased investment advisory services.[6]

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[3] Although the developments discussed in this petition for rehearing most directly support review on the issue of materiality, they also support review on the issue of loss causation because the lower courts' improperly narrow materiality inquiry also caused them to view loss causation too narrowly. *See* Petition, at 27-29.

[4] 545 U.S. ___, 74 U.S.L.W. 3199.

[5] Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, codified at scattered sections of 15 U.S.C.

[6] *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 29-30 (2d Cir. 2005), *cert. granted,* 545 U.S. ___, 74 U.S.L.W. 3199 (Sept. 27, 2005) (No. 04-1371).

The closely related case of *Merritt v. Merrill Lynch*,[7] cited in Petitioners' reply brief, remains pending on appeal before the Second Circuit. *Merritt* provides an answer to the first question presented by the Petition that deepens a Circuit-level conflict on how information outside a registration statement affects a Section 11 claim when it cannot be "proved," as Congress expressly required for a successful affirmative defense, that the purchaser "knew of such untruth or omission."[8]

In *Merritt*, research reports issued by Merrill Lynch on securities held by a Merrill Lynch mutual fund were affected by conflicts of interest. Merrill Lynch performed investment banking services for about one-third of the companies in the fund, and hoped to attract more investment banking business by issuing unjustifiably positive ratings on stocks their analysts actually considered poor. *Merritt* held that this information was "public knowledge" because of newspaper reports – none of them specific to Merrill Lynch, its mutual fund, or the securities at issue – describing the potential for conflicts of interest in the broker-dealer industry.[9]

This opinion from the leading securities venue deepens the Circuit-level conflict on information outside a misleading registration statement. The Third and Fifth Circuits look exclusively to "the 'total mix' of information

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[7] *Merritt v. Merrill Lynch & Co. (In re Merrill Lynch & Co. Research Reports Sec. Litig.)*, 272 F.Supp.2d 243 (S.D.N.Y. 2003); *see* Reply Br., at 3. The *Merritt* appeal was fully briefed by June 2004 and now awaits argument and decision. *Merritt v. Merrill Lynch & Co.*, No. 03-7978 (2d Cir.), docket as of Oct. 21, 2005.

[8] 15 U.S.C. § 77k(a).

[9] *Merritt v. Merrill Lynch*, 272 F.Supp.2d at 250-52 & n.7.

the document provided investors," except when information located outside the registration statement is indisputably "obvious" to a "reasonable investor," such as general economic conditions.[10]

The Seventh Circuit has taken a decidedly different tack, abandoning both the Congressionally mandated standard of actual knowledge for the "buyer's knowledge" affirmative defense and this Court's "reasonable investor" standard for determining materiality.[11] In *Wielgos v. Commonwealth Edison,* the Seventh Circuit excused an electric utility's indisputably inaccurate estimates of the time and expense required for licensing of its nuclear power plants "because professional analysts knew – although perhaps Wielgos did not – that Commonwealth Edison's estimates were biased." But the *Wielgos* court provided no evidentiary basis for what analysts purportedly knew and no legal basis for disregarding this Court's "reasonable investor" standard for materiality.[12]

The standard of the Third and Fifth Circuits, focusing on how a reasonable investor views the information actually contained in a registration statement, conflicts with the Seventh Circuit's standard of indulging inferences about what professional analysts might know.

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[10] *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371, 377 (3d Cir. 1993) (emphasis added); *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1448 (5th Cir. 1993).

[11] *See* 15 U.S.C. § 77k(a) (buyer's knowledge defense); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (materiality).

[12] *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 515 (7th Cir. 1989).

Both *Merritt* and the decisions below dramatically expand this Circuit conflict by dropping the only limiting factor of *Wielgos*. The Seventh Circuit recognized that a registration statement must always disclose "*firm-specific* information."[13] *Merritt* and the decisions below found no liability even when undisclosed information differed materially from industry-wide trends – even when, as in the instant case, Respondent alone knew that Petitioners' investment was most likely doomed to bankruptcy.

The *Merritt* case and the decision below demonstrate the continuing importance of this issue, splitting the Third, Fifth, and Seventh Circuits; no decision in the pending *Merritt* appeal can resolve the split. This Court should therefore grant the Petition.

II. Auditors Are Abandoning Their Obligation Under Section 11 to Ensure Full and Fair Financial Disclosure in Every Distribution of Securities.

The SEC has recognized that *Merritt* represents more than an isolated error. The SEC's *amicus curiae* brief urging reversal of *Merritt* identifies the case as part of a disturbing trend among participants in securities distributions to contend that materially misleading disclosures can be excused from both civil and administrative liability if the correct information could theoretically have been discovered by a highly sophisticated investor with unlimited

[13] *Id.* (italics original).

resources.[14] This Court should grant the Petition in the instant case because the trend represents an immediate threat to the SEC's enforcement authority as well as to public confidence in the nation's capital markets.

In early October, it became public that an AICPA committee chaired by Respondent's deputy chief executive had issued a draft white paper instructing its member auditors to refuse to disclose their knowledge of misinformation, illegal acts, or even outright fraud by company management in the "due diligence" process for securities distributions. Auditors would instead redirect such questions to the issuer's management.[15] As a leading financial journalist commented, that "may not help if they are the ones suspected of fraud."[16] Two leading trade associations, The Bond Market Association and the Securities Industry Association, along with the New York Bar's Financial Reporting Committee, have called on the AICPA to repudiate the white paper, saying it will put investors at risk as well as harming issuers by reducing public confidence in the transparency of the securities markets.[17]

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[14] Brief of SEC in *Merritt v. Merrill Lynch & Co.*, No. 03-7978 (2d Cir. filed June 22, 2004), at 2 & n.1 (available at www.sec.gov/litigation/briefs/merritt.pdf).

[15] American Institute of Certified Public Accountants, *Auditor Attendance at Due Diligence Meetings with Underwriters*, at 19 (Aug. 23, 2005) (available at www.nytimes.com/packages/pdf/business/20051006_NORRIS.pdf).

[16] Floyd Norris, *Are Auditors Not Doing Due Diligence?*, NEW YORK TIMES, Oct. 7, 2005, at B1.

[17] *See* Letter from Micah S. Green, *supra* note 1; Letter from Committee on Financial Reporting, *supra* note 2; Letter from Edward Forst, Chair, The Bond Market Association, and Daniel J. Ludeman, Chairman, Securities Industry Association, to Center for Public Company Audit Firms, American Institute of Certified Public Accountants, at 2-5

(Continued on following page)

Robert J. Kueppers, Respondent's deputy chief executive and head of the AICPA committee that produced the controversial white paper, claims that auditors' refusal to disclose their knowledge of fraud will not harm investors or the integrity of the securities markets "because no auditor would sign the required permissions for an underwriting to proceed if he or she had serious worries about fraud."[18] Yet in the case at bar, Respondent did exactly that. Respondent concealed its knowledge of the issuer's great risk of bankruptcy and of fictitious earnings reports that led to the conviction of the issuer's CFO for defrauding Petitioners and other investors.

This development demonstrates the importance of the issues presented by the Petition. Only a handful of audit firms review every publicly traded company. Those audit firms are abandoning their obligation to ensure full and fair financial disclosure as part of every distribution of securities. This Court should therefore grant the Petition.

III. This Court May Defer Deciding the Petition Pending Further Developments in *Merritt*.

In the interest of justice, this Court can exercise its power to defer decision on the petition for rehearing until the Second Circuit decides *Merritt*. In the *Ohio Power* case, this Court vacated an order denying a petition for

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(Oct. 6, 2005) (available at www.sia.com/2005_comment_letters/8683.pdf).

The Bond Market Association and the Securities Industry Association have frequently submitted *amicus curiae* briefs to this Court, most recently in *Merrill Lynch v. Dabit, supra*.

[18] Norris, *supra* note 16.